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Late payment penalties in leases:
Harbor Island Holdings v Kim, 2003
Roger Bernhardt

Commercial lease provision that effectively doubled rent in the event of breach by tenant was unenforceable penalty.

Harbor Island Holdings v Kim (2003) 107 CA4th 790, 132 CR2d 406 ____

Under a commercial lease, the amount of rent payable if the tenant complied with the lease agreement in every respect would be doubled in the event of any breach. To effect that condition, the lease provided that half of the monthly rent would be “deferred” and ultimately forgiven if the tenant complied with all lease obligations. At the end of the lease term, the landlord sued the tenant, seeking damages for the tenant’s breach (*i.e.*, failure to properly maintain the premises) and nearly \$250,000 for the doubled rent. The trial court awarded damages of \$14,000 for the failure to maintain the property, but held that the lease provision for the doubled rent was unenforceable as a penalty.

The court of appeal affirmed. Under CC §1671(b), a contract provision liquidating the damages for a breach is valid unless the party seeking to invalidate the provision establishes that it was unreasonable under the circumstances existing at the time the contract was made. Although the landlord gave a number of examples of how the tenant breached the lease, such as failure to provide the landlord with copies of maintenance contracts, the court was “at an absolute loss to imagine” how \$240,912 for the period in question could represent “the result of a reasonable endeavor by the parties to estimate a fair average compensation for any loss that may be sustained” for the failure to provide copies of maintenance contracts. The court noted the obvious lack of a proportionate relationship between the amount sought and the actual damages suffered by the landlord. The court also pointed out that the landlord had other remedies available, both under the lease and as provided by law, to compensate it for any breach by the tenant without recourse to the collection of an additional \$240,912 in damages as a penalty.

THE EDITOR’S TAKE: In this case, the monthly rent was increased from \$30,974 to \$96,934 when the tenant held over, but was then to be reduced by \$48,182 if the tenant fully complied with all the lease terms. Of those three numbers, only the last one is significant; although dramatically large, the tripling of the rent for staying on was not a problem. Many states impose double or triple rent for wrongfully holding over, and it is especially allowable when it is the result of a negotiation between the parties.

But what California (and other jurisdictions) do not allow parties to negotiate are provisions that over penalize a party for not performing his contractual obligations. Courts permit themselves to award punitive damages, but they do not authorize parties to provide for the same.

Despite the judicial prohibition, it is hardly surprising for one of the parties in the negotiation to feel strongly enough about the wickedness of the other’s breaching as to seek to exact a penalty in one way or another. Because liquidated damages provisions are common, that is one route to try, but the statutory presumption of the validity of these

clauses is rebuttable, and an unexplained doubling of the amount due is not likely to survive much scrutiny. The landlord here probably knew that and therefore sought a more effective disguise—a rent reduction for compliance rather than a rent increase for noncompliance. Since common law lawyers got away with this dodge for over 500 years by making payment the condition for terminating a mortgagee's estate rather than making nonpayment the condition for terminating the mortgagor's estate, it was worth a try.

Had I been drafting the agreement for the lessor, I would have tried to pretty it up further by having the rent actually paid, with a provision calling for its return at the end after full compliance by the tenant. However, this opinion tells me that would not have worked either. These judges were perceptive enough to see that a contingent liability is functionally the same as a contingent discount of the same amount.

Landlords can enhance their protection against defaulting tenants by recitals broadening the scope of their entitlement to damages under the rule of *Hadley v Baxendale* (1854) 9 Exch 341 (disallowing special damages unless other party had been made aware of them), and by getting large security deposits (and good security deposit provisions). But I doubt that they can really circumvent the restrictions of this case in terms of demanding a pound of flesh for every breach. —*Roger Bernhardt*